CHAPTER – I

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INTRODUCTION

Rationale of The Study:

The concept of Asset Liability Management (ALM) in commercial banks has gained considerable significance in India after the introduction of reforms in the financial sector. Further, reforms relating to the interest rate deregulation have propelled the ALM concept into prominence in the recent years. Many techniques of managing assets and liabilities originated in the seventh and eighth decade of the twentieth century in the developed countries, as a strategic response of banks to inflationary pressure, volatility in interest rates and severe recession which marked the global economy during that period.

In India, the Narsimham Committee Recommendations on Financial Sector Reforms (FSR) made during the last decade of bygone century, have paved way for new regulatory standards, better internal policy development and rapid advancement in information technology in the banking sector. Along with these developments a comprehensive technique of managing the entire bank balance sheet in a cohesive and coordinated manner has been developed and has been termed as "Asset Liability Management". As the Indian banks gear up to face stiff competition posed by foreign financial institutions the scope of this technique is expected to increase, to help the Indian banks in effective implementation of ALM process. Reserve Bank of India (RBI) has introduced the Asset Liability Management System as a part of the risk management and control mechanism in commercial banks vide its circulars, DBOD No. BP. BC. 94/21. 04. 098 dated September 10, 1998 containing draft guidelines & DBOD No. 8/21. 040098/99 dated February 10, 1999 containing final set of guidelines for implementation by commercial banks commencing from the financial year 1999-2000. As per these detailed guidelines commercial bank management are required to prepare on fortnightly basis following three statements and thereby adopt the ALM practices & procedures more comprehensively These statements are:

i) Statement of structural liquidity,

ii) Statement of Interest rate sensitivity, &

iii) Statement of short-term dynamic liquidity.

ALM is considered as a comprehensive risk management system that helps the commercial banks to manage different types of risks associated in banking business viz. Liquidity Risk, Credit Risk, Interest Rate Risk, Exchange Risk, & Operational Risk etc. RBI in its guidelines has emphasized that initially commercial banks should address the problem of liquidity risk and interest rate risk and thereafter cover other related risks like credit risk, forex risk & operational risk[1]. This study focuses on the theme that risk & return are positively co-related and commercial banks should not extend their business beyond risk tolerance limits even if the business is profitable.

Definitions of Asset Liability Management:

The Asset Liability Management has been defined in different ways. Some of the definitions provided by eminent bankers that capture the basic message of this technique are as under:

a) The process of managing the Net Interest Margin (NIM) within the Overall risk bearing capacity of the bank.[2]

b) The process of planning, directing, and controlling the flow, level, costs, yield and duration of the funds for the purpose of achieving financial goals & controlling financial risks.[3]

c) Coordinated management of the bank balance sheets to allow for alternative interest rates and liquidity scenario.[4]

d) An integrated approach to branch and financial management, requiring simultaneous decision about the types and amounts of financial assets and liabilities it holds or the Asset Liability mix and volume.[5]

The ALM technique is a converged version of several techniques which have been successfully employed by the bankers throughout the world for the past two - three decades to resist the pressure of highly volatile global financial environment. Though this process is too complex to practice, it is perhaps the only solution for the banks in post reform period of deregulatory framework to survive in the competitive environment requiring stress on the total balance sheet management. In other words secret of successful banking under deregulated, competitive & dynamic environment hinges on matching of assets and liabilities in terms of rates and maturity with a view to

obtain optimum yield. ALM is only an approach not a precise technique and its detailed formulations varies from bank to bank. It is short term in nature focusing day to day, week to week balance sheet management to achieve near term financial goals. The management of both Assets & Liabilities is pursued not merely for growth but with greater concern for quality, profitability & capital ratios.[6]

Concept & Availabe Framework:

As said earlier,the concept of Asset Liability Management has its genesis in USA & Canada in the seventh decade of the twentieth century. This was attributed to volatile financial environment, technological advancement, and an overall deregulation in the financial system. The cut-throat competition and strict provisioning requirements had made banking a riskier business. In this situation there was a need of a technique that could manage various holdings of remunerative assets in a manner that results in lesser cost and higher yields so as to maximize profits.[7]

ALM was one such technique that was involved in matching of short-term liabilities with short-term assets, medium and long term liabilities with medium and long-term assets. The scope and objective of this technique was in line with the role of a financial institution which converts the acquired money (Deposits) into long term assets (Securities investment, advance against movable and immovable assets) and always runs the risk of loosing out on account of interest rate volatility in the financial markets. It is at this juncture where ALM emerges as a tool for managing interest rates and increasing profitability.

The RBI guidelines provide conceptual framework for ALM system deals with management of total balance sheet dynamics with regard to its size and quality. This involves:

a) Quantification of different risks, and,

b) Decision making in relation to the Asset Liability structure for maximizing the interest earning within the framework of perceived risk

In other words, the ALM framework leads to an integrated approach towards financial management conditioned to simultaneous decision making with regards to types and size

of financial assets and liabilities, their mix and volumes so as to insulate the spread from moving in adverse direction. Thus, it is necessary for a banker operating under deregulated and competitive environment to align asset and liabilities in terms of rate and maturity with a view to obtain optimum yield.

Objectives of the Study:

The broad objectives of the study are:

1) Undertaking survey of existing literature on the subject in the post-financial sector reforms period in India.
2) Providing comprehensive information on various risks that exists in banking business and ALM process as a whole.
3) Examining prevalent practices of ALM in purposively selected commercial banks with reference to:
   - Management of Liquidity.
   - Management of various types of risks involved in banking business.
   - Ensuring an acceptable balance between Profitability, growth & risk and,
4) Developing a suitable reporting system/pattern for effective implementation & use of ALM technique in commercial banks.

All the above objectives have been analysed after,

i) Reviewing the interest rate outlook in the deregulated environment of the post reforms period.

ii) Analysing various types of risks involved in the banking business.

iii) Reviewing the actual performance vis-a-vis to projections in respect of certain key banking parameters like net profit margin, interest spreads and balance sheet ratios of a selected commercial bank.

In sum, the study aims to identify the process of management of the total balance sheet dynamics of business of banking.

Hypothesis:

This research has been designed to test the following hypothesis:

1) There is no impact of ALM on the Interest spread
2) The ALM does not have an impact on the Bank's Liquidity.

Scope of Study & Data Source:

- The Study is based entirely on the published Annual Balance -Sheet/ Financial Statements/Annual Plans (for strictly private circulation) of selected commercial banks.
- To examine the application and importance of ALM an in-depth study of a purposively selected large sized nationalised bank named as (Bank X) having a prominent base in Western & Northern region of India is undertaken. Study of Bank X involves data for nine years period i.e. (1994-95 to 2002-03). This period covers 4 years (April 1999-March 2003) after the issue of ALM guidelines by the RBI and a similar period (April 1994 -March 1999) prior to the implementation of these guidelines, to capture the performance of the bank with and without proper ALM strategy.
- Comparative analysis of four leading commercial banks viz. Bank of Baroda, Andhra Bank, Vijaya Bank & Canara Bank is undertaken to capture the comparative management of liquidity risks in these banks using available RBI guidelines. This section of the study is based on the data derived from the information published in the Annual Reports of respective banks under the additional disclosures for the Financial Year 2002-2003 (March – end).

Methodology Adopted:

- 3 - pronged approach has been adopted for the study:
  - I) Analysing the existing framework of the ALM process & measuring its efficiency.
  - II) Ascertaining methods of Quantification, Monitoring, & Management of different kinds of risk.
  - III) Ascertaining methods of strategic planning & decision making with regard to the Asset Liability structure.

Statistical Test:

For testing the above hypothesis the database of India's leading Public sector bank (referred to as bank 'X') has been selected. Data related to Interest earned, Interest expended, frequency of liquid assets, Interest spread etc. have been analysed and **Chi-square test** has been administered to test the Hypothesis.

Importance of The Study In Indian Scenario:

In the Indian perspective ALM refers to the management of deposits, credit, investments, borrowings, Foreign Exchange resources, capital with respect to capital adequacy and above all profit management. ALM has been formally graduated into the domestic banking parlance as part of the system of Memorandum of Understanding (MoU), by which commercial banks were required to submit a policy statement on their individual ALM system to the RBI at regular intervals. These regulatory submissions helped the banks in undertaking following exercise:

1) Estimating core source of funds i.e. deposits, Certificate of Deposits, and call borrowings etc.,
2) Prudential management of funds with respect to size and duration,
3) Minimising undesirable maturity mismatch so as to avoid liquidity problem, and
4) Reducing gap between Rate Sensitive Assets (RSA) & Rate Sensitive Liabilities (RSL) within the given risk taking capacity.

The first and foremost objective of all bank management is to maximise income while controlling the risk exposure. This requires banks to emphasise on interest margin or

spread , liquidity and capital which have desired maneuverability for attaining optimum level of income with acceptable risk. Hence, efficient management of NIM is the basic test of successful ALM.

Secondly, the test of a prudent bank management lies in its liquidity management. Liquidity needs of a bank arise when there are outflow of deposits due to withdrawal and non-receipt of expected inflow due to delayed repayment. As the sources of liquidity are spread across both sides of balance sheet, there is an imperative need to manage both the sides and integrate liquidity management with the overall ALM.

Thirdly, There has been significant development in the move to deregulate the interest rate regime on both asset and liabilities, thereby exposing both assets and liabilities to volatility risk of interest rate changes.

Fourthly, gradual dismantling of restrictions with regard to Foreign exchange transactions has exposed Indian banks to the risks associated with the fluctuations in the foreign exchange markets. Similarly, restricted relaxations allowed to domestic bank with respect to fixation of aggregate gap limit and cross currency position now require much better technique of ALM, enabling them to maintain their respective net exposure in foreign currency within their risk taking capability.

In India one of the major limitations for implementation of ALM is non- availability of appropriate model/reporting formats on the basis of which different components of this technique can be incorporated in various operations & activities carried out by banks in general. This study makes an attempt in providing a deep insight into various prevalent techniques being adopted by purposively selected prominent commercial banks in India in recent years for management of their total assets and liabilities. Of course, some of these techniques are part of ALM framework already provided by RBI. Secondly, based on the experiences gained the study attempts to develop certain suitable reporting pattern/system for use by all commercial banks in India. This would help in compilation of various Management Information System reports relating to ALM system, which will be helpful in minimizing various risk exposures generally associated with the banking business.

The present study is both descriptive and analytical in nature and is based on available published data and literature, Annual Reports & Annual Plans (strictly private circulation) of commercial banks.

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